DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 99-0176
State Withholding Tax
For the 1995, 1996, and 1996 Tax Years

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ISSUES

I. Employee Travel Expense Payments – State Withholding Tax.

Authority: IC 6-3-4-8(a); IC 6-3-4-8(g); I.R.C. § 162(a)(2); I.R.C. § 274(d); I.R.C. § 3401(a); I.R.C. § 3402; American Airlines, Inc. v. United States, 204 F3d 1103 (Fed. Cir. 2000); Treas. Reg. § 1.62-2(c); Treas. Reg. § 1.62-2(c)(5); Treas. Reg. § 1.62-2(f)(1); Treas. Reg. § 31.3121(a) to 1(h).

Taxpayer argues that the audit erred in determining that it was required to withhold state adjusted gross income tax from the amount of money it paid to its employees in the form of travel expense payments.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it is entitled to abatement of the ten-percent negligence penalty because – based upon industry standards and practices – it acted in good faith in deciding it was not required to withhold taxes on amounts it paid its employees for travel expenses.

STATEMENT OF FACTS

Taxpayer is in the construction business. Taxpayer performs construction work for customers both inside and outside the state. Taxpayer has its own regular employees and occasionally subcontracts work as necessary.

The Department of Revenue (Department) conducted a review of taxpayer's business records and income tax returns. During that audit review, the Department concluded that taxpayer had failed to withhold taxes on certain travel expense payments it made to its employees. Accordingly, the Department assessed additional amounts of withholding taxes. Taxpayer disagreed with this conclusion and submitted a protest to that effect. An administrative hearing was held during which taxpayer explained the basis for its protest. This Letter of Findings results.

I. Employee Travel Expense Payments – State Withholding Tax.

Taxpayer performs construction work at off-site locations. Each workday, taxpayer instructs its employees to travel directly from their homes to a particular construction site. The distance from each employee's home to the construction site varies as does the amount of time each employee needs to travel to that site. However, taxpayer regularly compensates its employees for the time spent in traveling from their homes to the construction site.

Taxpayer compensates each employee on the basis of the employee's hourly wage. Taxpayer compensates each employee on the basis of the distance from that employee's home to the site. An employee who needs one hour to travel to the site will be paid for that one hour. An employee, who needs two hours to travel to the site, will be paid for two hours. An employee who needs one hour to travel to the site and who is paid an hourly wage of $10 will be paid an extra $10. Another employee – who also lives one hour from the site but who is paid $20 per hour – will be paid an extra $20.

If a number of employees decide to carpool to the site, they will receive the same amount as if they each had traveled individually. If an employee rides along with the company truck to the construction site, that employee will receive the same amount as if that employee drove his or her own vehicle. Theoretically, if a employee traveled to the construction site Monday morning, took up temporary residence near the site for the remainder of the work-week and traveled home Friday afternoon, that employee would be paid the same amount as if the employee traveled to and from the construction site every day of the workweek.

The audit determined taxpayer had not withheld state and county taxes from the amounts paid as travel expenses. The audit concluded that these amounts were wages from which taxpayer should have withheld taxes. Taxpayer disagrees arguing that the amounts were simply reimbursements for the employees own expenses incurred as a result of traveling to and from work.

Every Indiana business – which is required under federal law to withhold, collect, and remit withholding taxes to the Internal Revenue Service on wages paid employees – must also withhold Indiana withholding tax on those same wages. IC 6-3-4-8(a). If the Indiana employer fails to withhold the state tax from its employees' wages, the employer itself becomes liable for the tax. IC 6-3-4-8(g).

Taxpayer argues that because it was not required under federal law to withhold taxes from the travel compensation payments, it was not required to do so under Indiana law.

I.R.C. § 3402 requires employers to withhold wages for payment of an employee's income taxes. "Wages" are defined as including "all remuneration" subject to stated exceptions. *See* I.R.C. § 3401(a). One of these exceptions includes amounts paid employees as "traveling and other expenses." The expenses are defined at Treas. Reg. 31.3121(a) to 1(h) which states:

> Amounts paid specifically—either as advances or reimbursements—for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer are not wages and are not subject to withholding. Traveling and other reimbursed expenses must be identified either by making a separate payment or by specifically indicting the separate amounts where both wages and expense allowances are combined as a single payment.

The employer's obligation to withhold federal (and state) taxes from an expense allowance depends on whether the amount is paid under an accountable or a non-accountable plan. Treas. Reg. § 1.62-2(c). *See* I.R.C. § 274(d). Expenses that are reimbursed under an accountable plan are not reported as income. Any expense amounts paid under a non-accountable plan must be included in the employee's income, and the employer must withhold taxes. Treas. Reg. § 1.62-2(c)(5).

> A plan under which an employee is reimbursed for expenses – or receives an allowance to cover those expenses – is an accountable plan only if three conditions are satisfied: (1) there must be a business connection for the expenses; (2) the employee must either substantiate or be deemed to have substantiated the expenses; and (3) the employee must return to the employer amounts in excess of the substantiated expense. Treas. Reg. § 1.62-2(c).

Although I.R.C. § 162(a)(2) allows a deduction from an employee's income for ordinary and necessary business expenses including the employee's travel expenses, no deduction is allowed unless the person claiming the deduction meets the substantiation requirements of I.R.C. § 274(d). Therefore, unless taxpayer reasonably believed that its employees were keeping adequate records of their traveling expenses to meet the substantiation requirements of I.R.C. § 274(d), taxpayer had no reason to assume that the employees could exclude from their gross income the amount taxpayer paid as travel expenses. American Airlines, Inc. v. United States, 204 F3d 1103, 1106 (Fed. Cir. 2000).

Taxpayer paid each employee a travel allowance based upon the number of days the employee worked and the distance that employee lived from the current work-site. Whether the employee drove those miles each work-day, whether the employee car-pooled with other employees, or whether the employee rode with the taxpayer's truck to the worksite was not relevant to the amount of travel allowance actually paid. There is no indication taxpayer expected the employees to substantiate their actual travel expenses or that the employees would be entitled to exclude that portion of their wages as travel expenses. Taxpayer's travel allowance payments do meet the substantiation requirement because the plan was not reasonably calculated not to exceed the amount of expenses or anticipated expenses are required under I.R.C. § 274(d).

The federal regulation requires an employee to return to the employer with a reasonable time any "amount paid under the arrangement in excess of the expense substantiated in accordance with paragraph (e) of this section." Treas. Reg. 1.62-2(f)(1). Under taxpayer's travel allowance plan, each employee was paid an allowance based, in part, on that employee's hourly wage. There is no indication those employees whose travel allowance exceeded their actual expenses ever returned or were ever expected to return any portion of the allowance payment to the taxpayer. This conclusion goes hand-in-hand with the determination that no employee was ever expected to substantiate their actual expenses.

There is insufficient information to establish whether or not taxpayer ever paid the travel hours "by making a separate payment or by specifically indicating the separate amounts . . ." as required under Treas. Reg. 31.3121(a) to (h). Nevertheless, taxpayer's travel allowance plan was not an "accountable plan" as defined under Treas. Reg. § 1.62-2(c) because the travel allowance payments were not calculated to reimburse its employees for the expenses each employee actually incurred in traveling to and from the worksites as required under I.R.C. § 274(d).

Taxpayer paid its employees for the time they spent traveling to and from their workplace. The payments were made in exchange for time the employee was reasonably expected to spend in traveling to the workplace. As such, the payments constituted wages for which taxpayer was required to withhold federal, state, and county taxes.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer argues that it is justified in requesting the Department to exercise its discretion to abate the ten-percent negligence penalty assessed at the conclusion of the original audit examination. Taxpayer maintains that its practice of paying its employees for time spent in traveling to and from the worksite – and not withholding income taxes – is a common practice in the construction industry. In addition, taxpayer maintains that there are no Indiana appellate or Supreme Court decisions directly addressing this issue. Further, taxpayer states that the Department has not addressed the issue in any previous Letter of Findings, Revenue Ruling, or Information Bulletin. Taxpayer points to a number of judicial precedents addressing the question which taxpayer states are "inconsistent at best." Taxpayer also states that the issue was not raised in any of the Department's previous audits.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer has demonstrated that its failure to withhold state income taxes was "not due to willful neglect."

FINDING

Taxpayer's protest is sustained.

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